Basis Points

Weekly Market Commentary

Basis Points – October 11, 2018

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Above the Fold

Stocks take the stairs up and the elevator down, the old saw goes. That certainly happened Wednesday, with the second largest Dow point loss of the year.

The equity markets declined sharply yesterday, with the S&P 500 losing 3.3 percent on the day, the worst daily performance in six months. The S&P 500 remains up 5.8 percent for 2018, however. While the stock market was quiet and friendly in the third quarter of 2018, the fourth quarter is shaping up to be much less hospitable, only 10 days into October. There was no new specific news that drove the selloff, only continuing worries about rising rates that have increased over the past few weeks. However, the benchmark 10-year bond was relatively stable all day, with its closing yield of 3.20 percent down only slightly from 3.23 percent on Tuesday.

The market swoon may have been a perfect storm of no company news, no buybacks, fears of rising rates and a growth stock group that was overdue for a spanking.

There was no earnings release news to blame the selloff on, as companies are still in a quiet period before the mass of earnings reports begin next week. Also, companies cannot buy back their stock in the month prior to an earnings release, so that lack of demand for shares could have played a part in the sharp downturn. There are many buyback programs in place, and that buying could have helped mitigate the decline somewhat. But it is the wrong time of the quarter to get help from buybacks.

The story underneath the broad selloff is the skirmish of growth vs. value, and technology stocks, specifically. While the S&P 500 made a new all-time high as recently as Sept. 21, the FAANG index, made up of huge technology companies, made its last high on June 21 and has been losing ground ever since. The FAANG index is now 16.4 percent off its recent high, so while not in bear territory yet, it seems to be headed there given the sharp recent weakness in the group.

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The Russell 1000 Value index declined 2.3 percent on the day, while the Russell 1000 Growth index lost 4.0 percent. The FAANG index dropped 5.5 percent. The growth area of the market was overdue for a correction, as through Sept. 30, it had outperformed value over the last 12 months 26.3 percent vs. 9.4 percent. Beginning in June, investors have certainly taken chips off the table in many former high flyers, such as Facebook (down 25 percent since June 21) and Netflix (down 22 percent).

The usual suspects outperformed in yesterday's decline, as the Utilities and Consumer Staples sectors declined much less than the overall market. Oil slid $2 on the day to $73 a barrel.

Two Things

- Home sales are hurt by higher interest rates, as buyers must pay higher costs to buy the same home. Homebuilding stocks have been crushed lately due to their exposure to the higher rates that are worrying the financial markets so far this quarter. The homebuilder stocks are in bear market territory, as the iShares Home Construction ETF has declined 25 percent this year. The outlook for the sector has become tentative with the average 30-year mortgage rate recently hitting the crucial 5 percent level. The run-up in rates over the past year is now weighing increasingly heavily on single-family housing demand, particularly since housing prices had risen so sharply. With higher mortgage rates, affordability could now be an issue for many potential homeowners. Existing home sales for August were unchanged, at a rate of 5.34 million units, but that follows four straight months of declines.
- The Brookings Institute reports that this month is a tipping point in history for global poverty numbers. For the first time in history, the majority of humankind is no longer poor or vulnerable to falling into poverty. As of this month, just over 50 percent of the world's population, or 3.8 billion people, live in households with enough discretionary income to be grouped under their definitions of "middle class" or "rich." Beyond lifting people out of grinding poverty, this middle-class tipping point is important for global citizens as the middle class drives demand in the global economy and because the middle class is far more demanding of their governments. And the new middle class is predominantly Asian. Almost nine in 10 of the next billion middle-class consumers will be Asian. By 2030, the world's middle class will grow by 1.7 billion more people than today, and the poor class will have 900 million fewer people.

Did You Know

The *WSJ* reports that a large class of would-be retirees are finding their timber-based retirement plans a far less lucrative investment than they planned.

During the early 1900s, many millions of acres of forest in the southeastern U.S. were cut down and turned into farm and grazing land. However, too much land was used for farming, and farmers suffered through a long period of low harvest prices. At the depths of the 1980s farm crisis, the Reagan administration launched the Conservation Reserve Program. Starting in 1986, it promised farmers annual payments of about $30 to $50 for each acre they planted with trees or grasses.

As a result of the government incentives, timberland rose sharply in popularity as an investment idea, and many seized the government's offer. People reasoned that trees would grow, and thus gain value, no matter what the stock market did. Investors large and small snapped up forestland that big paper companies put on the market to take advantage of the interest.

By 1994, more than 4.7 million acres of farmland in the South had been converted to pine plantation, much of it in Mississippi, Alabama and Georgia. But the idea's popularity has led to its ruin 30 years later. The region has more than 6 million owners of at least 10 wooded acres, most of who want to cut their trees and send them to market now.

Many of the family tree farm owners were counting on forests as a long-term investment that could be replenished and passed on to heirs. But just as these retirees are ready to reap their 30-year harvest, a glut of timber has piled up in the Southeast. There are far more ready-to-cut trees than the region's mills can saw, pulp or use. The huge supply has crushed timber prices in Mississippi, Alabama and several other states, leaving retirees with a lot of trees but very little money to show for their 30-year investment.

The timber glut has also been a big loser for some large institutional investors, such as the California Public Employees' Retirement System, who spent more than $2 billion on southern timberland, and harvested trees at depressed prices to pay interest on money borrowed to buy it. Calpers sold much of its land this summer at a loss.